Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:MIA:POSTF-162081-01
DRSmith

date: February 11, 2002

to: Moris Uhler, Revenue Agent
LMSB 1207:FS, Plantation POD

from: Associate Area Counsel, LMSB, Miami, FL

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subject: [redacted] (EIN: [redacted])

This responds to your request for legal advice dated October 12, 2001.

This memorandum contains nondocketed significant advice which is subject to a 10-day post-review in the Office of Chief Counsel. Therefore, please take no action to implement the advice contained in this memorandum until the expiration of this 10-day period.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

INDUSTRY COUNSEL CONTACTS

This memorandum was sent by e-mail to [redacted], and Joseph Grant, IC for Change of Accounting Method, for their review prior to issuance. Both of them responded that they had no problem with anything in the memorandum.

FACTS **20134**

In late 1996, the taxpayer, a small business corporation whose sole shareholder is [redacted], placed a purchase order for a [redacted]. The company acquired the [redacted] at a cost of approximately $[redacted], and placed it in service on or about [redacted]. The taxpayer entered into a contract with [redacted], located at [redacted], to provide management services for the [redacted]. Each

month [redacted] submitted to the taxpayer an invoice which included its services rendered, which consisted of all operating expenses incurred with respect to the [redacted], including providing [redacted]. Monthly summaries of [redacted] were provided, along with detailed [redacted] schedules. During the years [redacted] and [redacted], the taxpayer's primary business activity was [redacted]. In early [redacted], the company also acquired the [redacted].

The taxpayer submitted to the examining agent the monthly summaries and detailed [redacted]. In accordance with Treas. Reg. § 1.61-21(g), the taxpayer provided its Standard Industry Fare Level (SIFL) computations, which showed a breakdown between business and personal mileage [redacted]. Based upon the information provided by the taxpayer, during the year [redacted] the [redacted] was used [redacted]% for business use and [redacted]% for personal use. On its Form 1120S for [redacted], the taxpayer deducted direct operating costs of $[redacted] as "other deductions - transportation". This represented all direct operating costs of the [redacted], for both business and personal [redacted]. In computing depreciation, the taxpayer uses the double-declining balance method, half year convention, and a useful life of [redacted] years, and is depreciating its full cost basis. The taxpayer claimed depreciation on the [redacted] in the amounts of $[redacted] and $[redacted] for the tax years [redacted] and [redacted], respectively.

ISSUE #1

Whether the taxpayer can claim [redacted]% depreciation on a company-owned [redacted], even though the [redacted] is used for both business and personal purposes?

DISCUSSION

The primary question is whether depreciation can be claimed using the entire cost basis of the [redacted], even though the [redacted] was used more for personal use than business use during [redacted]. In support of its position, the taxpayer cites the case of Sutherland Lumber - Southwest, Inc., v. Commissioner, 114 T.C. 197 (2000), aff'd. per curiam, 255 F.3d 495 (8th Cir. 2001). This case has been followed by the Tax Court in two more recent cases, National Bancorp of Alaska, Inc., v. Commissioner, T.C. Memo 2001-202; and Midland Financial Co. & Subsidiaries v. Commissioner, T.C. Memo 2001-203. In each of these cases, the Service argued unsuccessfully that the operation of Section 274 served to limit the taxpayer's deduction for operating expenses to the amounts treated by the taxpayer as compensation to employees.

In these three cases, the Tax Court held that the exception under I.R.C. § 274(e)(2) removes the expenses in question from the limitations and restrictions otherwise imposed by I.R.C. § 274(a). Thus, the allowable deductions with regard to the operation of the aircraft are not limited to the amounts of income reported by its officers and employees, as the Service had contended. The Tax Court resolved the disagreement over the language "*to the extent that* the expenses are treated by the taxpayer. . . as compensation to an employee. . ." by holding that I.R.C. § 274(e)(2) acts as an exception to § 274(a), and not as a limitation on the amounts which may be deducted. Sutherland Lumber-Southwest, Inc., v. Commissioner, supra.

While the Sutherland Lumber opinion discusses I.R.C. § 162 as the operative statute which allows the business expense deductions in question, rather than I.R.C. § 167 (depreciation), this distinction does not appear to lead to any difference in tax treatment. In National Bancorp. of Alaska, the expenditures associated with the fringe benefit compensation included depreciation on the aircraft, and these amounts were allowed as well as the Section 162(a) expenses, on the theory that all such amounts may be treated by the corporation as deductible compensation. The key is that the taxpayer must keep the necessary records that show the breakdown between business and personal use of the facilities, and issue Forms W-2 to employees requiring them to include the fringe benefit compensation in gross income.

Issue #2

Since the business use of the [redacted] for the year [redacted] is less than [redacted]%, can we compel the taxpayer to use the MACRS alternative depreciation system in computing its depreciation deduction?

Discussion

I.R.C. § 280F provides special limitations on the depreciation of a class of property called "listed property" (defined under § 280F(d)(3)(A)) that includes [redacted]. I.R.C. § 280F(b) provides that, if any listed property is not used predominantly in a qualified business use for any taxable year, the depreciation deduction for the property for that year and any subsequent year shall be determined under I.R.C. § 168(g) (relating to the alternative depreciation system). The phrase "predominantly used in qualified business use" is defined in § 280F(b)(3) as over [redacted]% business use; in addition, Treas. Reg. § 1.280F-6T(d)(2)(ii)(A) excludes use by certain persons from the calculation of qualified business use.

The regulations also provide special rules for [redacted] under which a taxpayer with a qualified business use of at least 25% (excludes uses by persons described in Regs. § 1.280F-6T(d)(2)(ii)(A)) may also consider use of the [redacted] by such persons as qualified business use in determining whether the predominant use standard has been met. See, Regs. 1.280F-6T(d)(2)(ii)B). But in determining if the taxpayer has the requisite [redacted]% qualified business use, one must include both direct use in the business activities of the taxpayer (e.g., product delivery) and use provided as compensation for services by any person (other than a [redacted]% owner or related person, as defined in Regs. § 1.280F-6T(d)(2)(ii)(C)), provided an amount is properly reported by the taxpayer as income to such person and, where required, there was withholding under Chapter 24. See, Regs. § 1.280F-6T(d)(2)(ii)(B).

In this case, the overall business use of the [redacted] for the year [redacted] was [redacted]%. This is below the [redacted]% business use threshold in the regulations. But you must also include in the calculation the non-business use by individuals who were not [redacted]% or more owners which represented compensation for services to such persons, and to whom Forms W-2 or 1099 (or other similar information returns) were issued, and taxes withheld. If the total "qualified business use" was less than [redacted]%, then the [redacted] should be depreciated under the alternative MACRS straight-line method for the tax year [redacted] and all succeeding tax years, in accordance with I.R.C. § 280F(b)(1).

Issue #3

Does the exception under I.R.C. § 274(n)(2) apply here for [redacted] provided to [redacted] during personal use of the [redacted]? Does this exception apply for [redacted] provided for [redacted] and [redacted] during business use of the [redacted]?

Discussion

The short answers here are "yes" and "no". The exception under Section 274(n)(2)(A) by its terms applies in the case of any expense described in subsection (e)(2), which covers any expense treated by the taxpayer as compensation to an employee. This exception applies to [redacted] provided for the [redacted] during either business or personal use of the [redacted], under the reasoning set forth above. We think § 274(n)(2) exception would not apply in the case of [redacted] provided to the [redacted] during business [redacted]. However, I.R.C. § 162(a) permits deductions for these items as ordinary and necessary business expenses. On business [redacted], § 162(a) is not preempted by § 274(a). Also,

the [redacted]% limitation under I.R.C. § 274(n)(1) would not apply here.

Issue #4

Since the [redacted] was used [redacted]% for personal use in [redacted], does this make it an "entertainment facility" under I.R.C. § 274(a)(1)(B)?

Discussion

The answer to this question is immaterial, since, in situations in which Section 274(e) applies, it renders all provisions of Section 274(a) inapplicable.

If we can be of further assistance, please let us know.

David R. Smith

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